RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P.O. Box 1759, La Jolla, California 92038
36 Letters per year — $150 Annually
Registered with the Securities and Exchange Commission

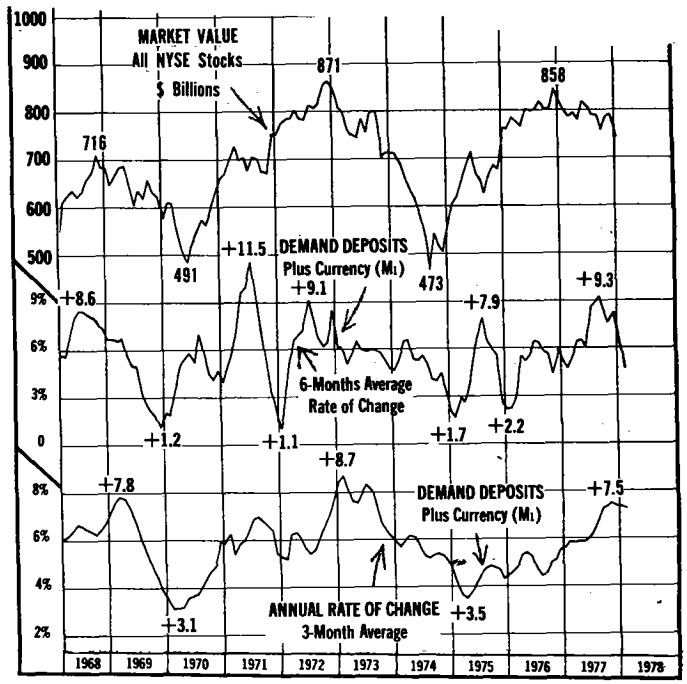
April 5, 1978 **LETTER 726**

Mar. 23, DJIA 756.50; PTI 728; A-D Ratio –20.79
Mar. 31, DJIA 757.36; PTI 726; A-D Ratio –20.61

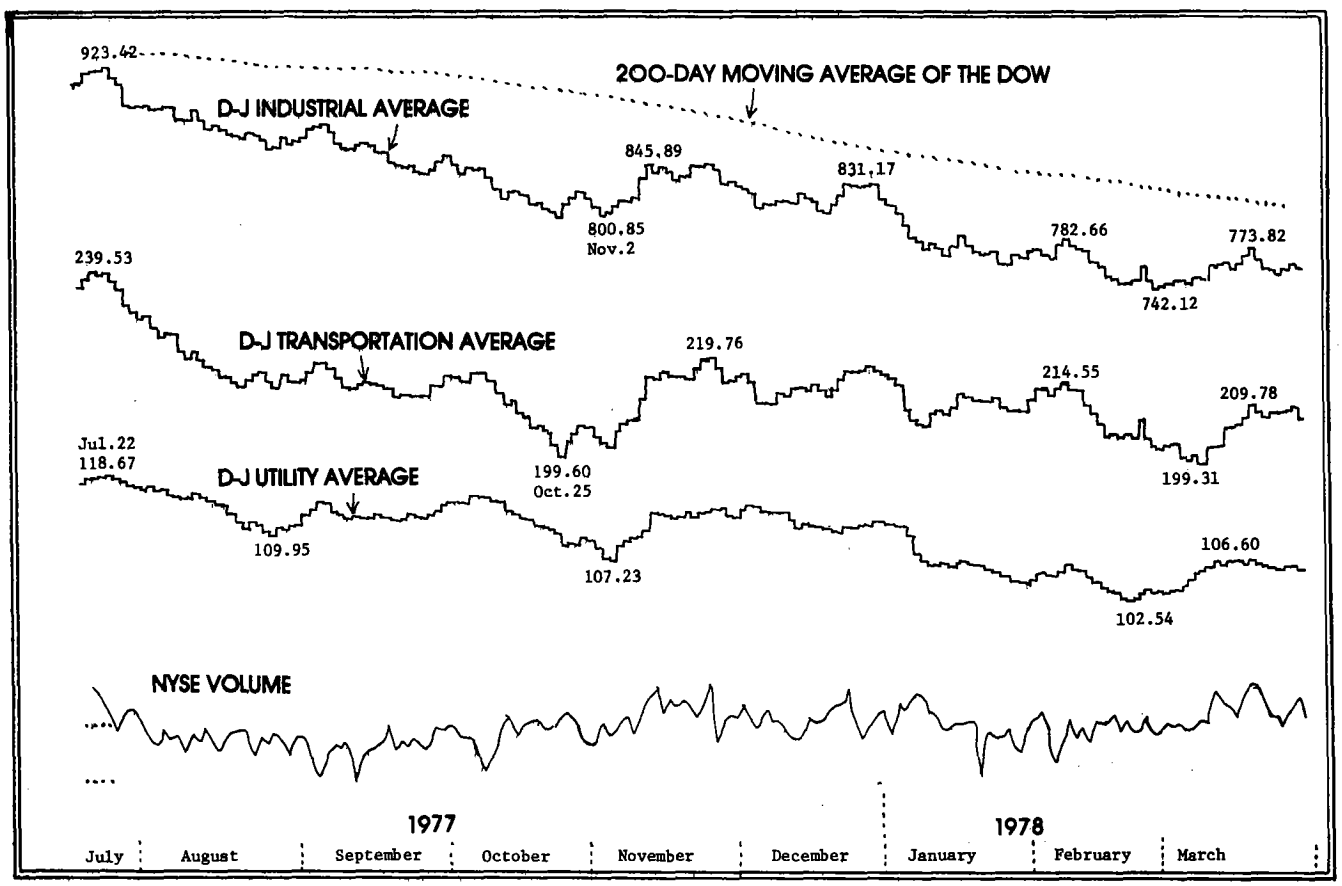
KNOWN BY ALL: What's the best known concept on Wall Street today? That's easy, it's that the big stocks (as exemplified by the Dow issues) are down or going down while the secondary issues are up or going up. Therefore, all you've had to do over the past year in order to make money was to sell your MMM and Kodak and IBM and buy a list of NASDAQ or AMEX champions. Furthermore, brother, you can still do it. The plums are hanging on the trees.

Anyway, that's the concept, and it's well known by one and all. My own view of the picture is that we've been seeing a huge distribution of the highly liquid stocks (i.e., the big stocks that have a wide market), and a huge accumulation of the low liquidity stocks (i.e., stocks that tend to have a small market, and, on occasion, almost no market at all).

I don't usually begin these reports with a fundamental note, but at this time I want to start with a few "monetary furndamentals." First, there is a record $9.78 billion in NYSE margin debt overhanging the market. Following a steady rise since late-1974, the margin debt has (over the past few months) been leveling off. My guess is that the next major direction of the margin debt will be down, and that implies a liquidation phase in the market. If I had to guess, I would say that the liquidation will be seen to a large extent in the secondary issues, the issues which have been so avidly gobbled up over the last year.



Next, I want to include this chart from Bill Bretz's *Juncture Recognition* report (he'll send you a copy if you write to Box 1209, Pompano Beach, FL 33061). I believe this chart is telling a vital story. Line 1 on the chart is a profile of the total value of all NYSE issues. Note how closely stock values follow line 3, which is the **annual** rate-of-change in the M-1 money supply.



Line 2 is a more sensitive index of M-1, a **6-month** rate-of-change index. Persistent movement in the 6-month index usually shows up on the one-year index within a short period of time.

The operative factor at the moment is that the 6-month index is now diving to lower levels.

The 6-month rate-of-change for the end of February (this is what we see on the chart) is down to plus 4.7%. The 6-week rate-of-change calculated as of March 8 is minus 3.8%. Now I don't really know why this contraction is occurring. It could be that the Fed is putting the brakes on the money supply because of the inflationary trends. It could be that they are shrinking the money supply in order to defend the sagging dollar. Or most likely, it could be that the money supply is simply out of the Fed's control. But one way or another, the rate-of-change in M-1 is sliding, and if past history means anything, the stock market should follow the annual M-1 rate-of-change. If so, then the $9.78 billion in margin debt could be a heavy burden on Wall Street.

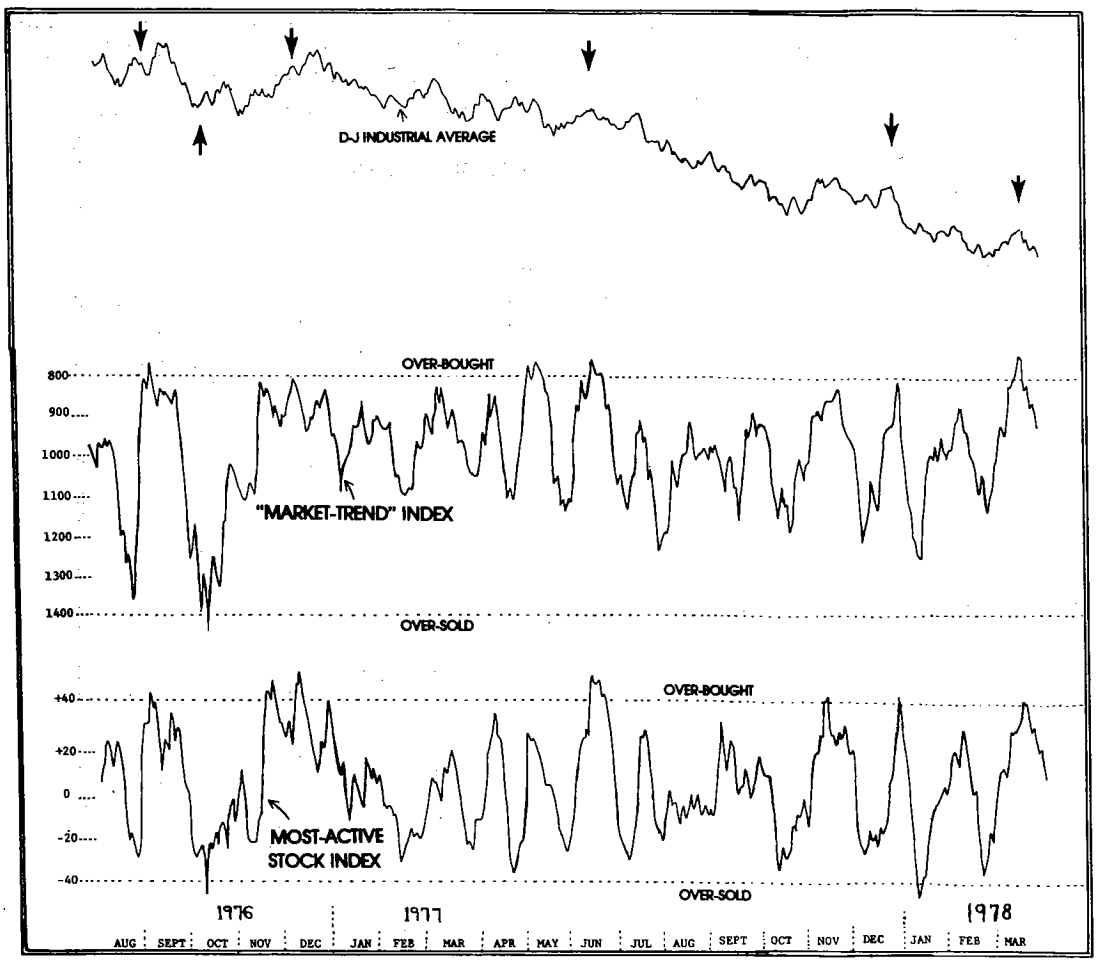
Turning to the page 1 graph of the Averages, the picture is clear enough and really simple enough. The three Averages have been rallying off their recent February-March lows as shown on the chart. We have a March 9 low of 199.31 for Transports, a February 22 low of 102.54 for Utilities, and a February 28 low of 742.12 for Industrials. The question: will those lows hold?

If we listen to the bulls (and there are a gathering number of them), a bottom is building and the lows have been seen. Maybe so, maybe so, but my data registered very over-bought on March 17, and my indices have not substantially changed that reading since. The thing to do here is to let the market tell its own story. If the technical situation can build up (i.e., turn positive) and the February-March lows can continue to hold, I'll be impressed. I sure don't think that's going to happen, but never let it be said that Richard Russell argued with reality. My guess (based on my own studies) is that in due time this market is going to turn down and the Averages will break to new lows. In the meantime, nothing will be lost by awaiting the cold, hard verdict of the market.

It is important to understand that in the stock market (as in our own businesses or in our lives) we must have a METHOD of operation. The road to disaster is to buy stocks emotionally when the market "looks like it's going higher" and to sell stocks emotionally when the market "looks scary and lower." The method I use, and the one I ask my readers to follow, is this: we buy stocks in those areas that can be *identified* as major (or sometimes intermediate) bottoms. We sell stocks at those areas that can be *identified* as important tops. We don't move on our emotions, we don't move on our "seat-of-the-pants" instinct, we don't move on gossip or rumors or the consensus opinion. We move when the technical evidence says "move." So much for that.

Turning to the over-bought and over-sold indicators (page 2), it is clear that the market has been repeating "the same old story." As noted in the last Letter, my two indicators registered over-bought on March 17. One trading day later, on March 20, Industrials recorded a rally peak of 773.82, Transports a rally peak of 209.78. A minor decline followed, but the subsequent rally has (so far) failed to take the two Averages above their March 20 highs. Furthermore, my two indicators (see chart) are still in the over-bought zone.

Thus, the market has expended a lot of energy on the upside, enough to produce another over-bought situation on my indices. But the steam failed to take the Averages even above preceding minor peaks. Unimpressive action, as far as I'm concerned.



TIMING, WAITING, AND FIGURING: Circulation of these Letters has better than doubled during the past four years. This brings the subscription list to around its highest level since I started Dow Theory Letters back in 1958. Consequently, I want to take this paragraph to thank all my subscribers, old and new, veterans and neophytes, bright-eyed ones and the bleary-eyed ones, for their faith and indulgence.

One of the great advantages of this kind of readership is that it allows me to exchange, purchase, beg or borrow the kind of information I need. But more importantly, it means that some of the really outstanding (and original) people in the industry are kind enough to keep me abreast of their thinking. And when it comes to the stock market, I'll walk 100 miles for a single good idea.

All of which brings me to two studies that I now want to discuss. The first is our old friend, Fibonacci. This is a

study which is really a part of the Elliott Wave Principle. As many readers know by now, Fibonacci is based on a numerical series which occurs so frequently in nature that it must be judged "beyond coincidence." The series is produced by adding each two preceding numbers to obtain the next. For instance, 1 plus 1 equal **2**, 2 plus 1 equals **3**, 3 plus 2 equals **5**, and so on to 8, 13, 21, **34**, 55, 89, etc. These Fibonacci series numbers appear over and over again in nature. For instance, the age of maturity is 21, 5 appendages on the human body (head, two arms, two legs), 13 the beginning of teen-age, number of notes in an octave is 8, etc.

At any rate, readers know that I have been "looking for" a major bottom which would end this current down-leg in the bear market, a bottom that should materialize either this year or in 1979. One of my subscribers, W.P. of Pittsburgh, PA, has been doing a good deal of work on the Fibonacci series, and he has come up with the following most interesting projections.

3 years from the 1976 top to 1979.
5 years from the 1974 bottom to 1979.
13 years from the 1966 top to 1979.
34 months from the Sept. 21, 1976 Dow top to July, 1979.
55 months from the Dec. 1974 bottom to July, 1979.

W.P. also makes the following interest (and rather depressing) observations:
Dow decline from Feb., 1966 to Oct. 1966 took 8 months.
Dow decline from Dec. 1968 to May, 1970 took 17 months.
Dow decline from Jan., 1973 to Dec., 1974 took 23 months.
Dow decline from Sept. 1976 to July, 1979 would take 34 months.

My own conclusion based on these figures is that this major down-wave of the bear market could hit a temporary bottom during 1978–and then a major bottom in or around July, 1979.

I want to talk about a second study which, to my mind, is very much in line with the above Fibonacci projections. This second study is based on the weekly data published by the fine *Lowry's Reports* (350 Royal Palm Way, Palm Beach, FL 33480). Lowry's follows 280 major NYSE issues on the basis of their own proprietary formula (the formula takes into account relative strength, up-ticks and down-ticks and time studies). The result is a weekly "power rating" on each of these stocks. Lowry's also computes a weekly "average power rating" (APR) based on the combined ratings of all 280 stocks. Over the past 29 years the APR's have moved within a range of 55 (at the high) and 5(at the low).

A study of Lowry's history indicates that any time the APR's sink to 15 or below, the market is extremely over-sold. The market is then also considered to be in a major buying area. One of the fascinating points about the APR's is that since 1949, through booms and slumps, through inflation and stag-flation, through periods of optimism and pessimism, there has NEVER been a period of more than four years without a drop by the APR's into the 15-or-below major over-sold area.

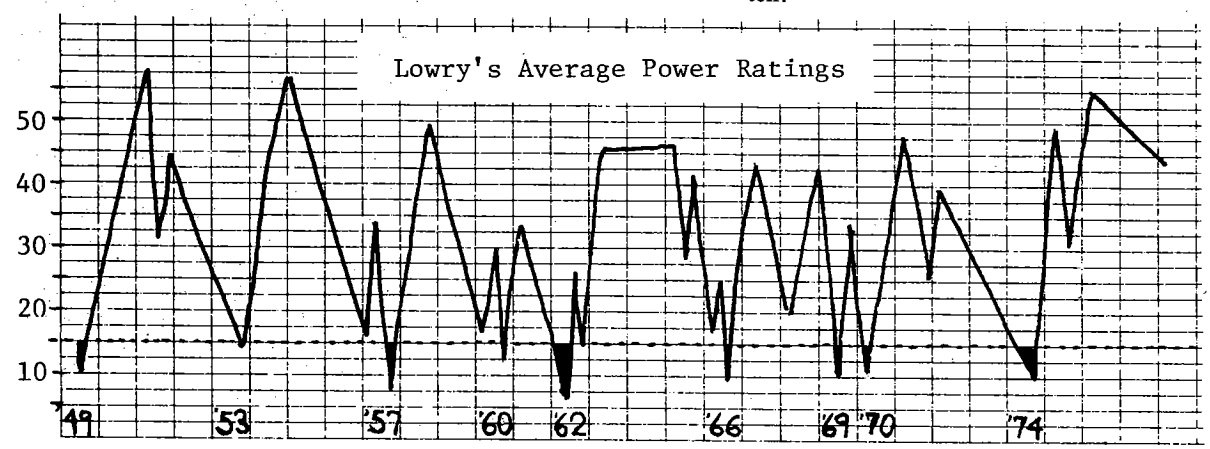
I have drawn a little chart showing the 29-year history of the APR's. The dates at the bottom of the chart identify those years in which the APR's dropped to the major over-sold area. Since 1949 there have been 9 such areas of "great buying opportunity," or an average of one such area every 3.2 years. Note also that the last year in which a major over-sold in the APR's appeared was 1974.

What does this mean in terms of the market today? Since there has **never** been a period of over four years without a major over-sold bottom, it means that the odds are heavily in favor of such a bottom's occurring during 1978.

Note also that the APR's have held in a rather high area ever since early 1976. This implies that we have been witnessing an extended area in which the market has remained over-bought. This over-bought area makes me believe that when the over-sold condition finally does arrive, it's going to be a whopper.

The question might be asked, "What if the market makes history by avoiding the full over-sold bottom during 1978?" My answer is this: As a rule, when a natural rhythmic pattern is held back in the stock market, it generally strikes with even greater strength at a later date. For this reason, I would say that if the market does not slump to a major over-sold in 1978, we're going to see one lulu of a smash during 1979. Such a decline could dove-tail with the projection of the Fibonacci series, a projection which points to a major bottom during 1979.

An immediate question that arises is this: the Lowry study suggests a major bottom in 1978, while the Fibonacci series suggests a major bottom in 1979 (July, 1979 to be exact). Which one is liable to be correct? Here I will have to lean on the idea that has preserved my sanity time and time again. "Predictions" are dramatic and ego satisfying, but they are very tenuous when it comes to the stock market. Therefore, seasoned market students learn that it is far better to IDENTIFY a bottom than to attempt to predict one. Perhaps we will get a secondary bottom in 1978 and the major bottom in 1979. Only time will tell.



Parenthetically, I cannot help but wonder whether 1979 won't be the year that makes Mr. Erdman a prophet via his best selling book, "The Crash of '79." So far, his crystal ball has been looking pretty good.

GREAT DEBATE: Question: Russell, you keep talking about the immense debt structure in the US and among its citizens. You talked in Letter 724 about the downturn in the 55-month moving average of the Dow. You're showing us a giant head-and-shoulders bottom in gold. What does all this mean, and what do we do about it?

Answer: I can't give you the exact answer, but I can tell you the problem. In all history there has never been a debt edifice that has not been liquidated. The bigger the debt structure, the more urgent the ultimate forces of liquidation. At some point, people must and will question the towering US debt structure, and at that point the liquidation will begin. Already,

obviously, the fall of the dollar is one way the world market is questionning the US debt. The sliding dollar is saying, "Look, we just don't trust the purchasing power of your money any more. You're printing too much of it, we can't handle it all, we don't want that much of it. Anything that comes out that easily and in that kind of quantity is suspect. It takes work to produce gold, autos, TV sets, or to produce and collect stamps or coins. But it just takes a Government printing press to produce dollars."

Now the debt can be liquidated in a number of ways. You can renege on it; just declare bankruptcy. This is one possibility. Or you can try to inflate your way out of debt, which is what the US has been doing. A million dollars of debt in 1935 was huge. Today it's nothing. Or you can cut costs, deflate, make ends meet, and actually pay off your debt. It has been done, but this route takes determination and it's very painful.

Question: OK, Russell, you've described the problem. But which path do you think we'll follow, and what do we do about it?

Answer: I think without question the Government will follow the path of inflation. They'll follow it as long as they can, which means as long as anyone will accept printing press money. When the dollar becomes unacceptable, the trouble starts. We may be moving into that area, but we're not there yet.

The fact is that there are now over $500 billion US dollars overseas, and that's $200 billion more than the basic US money supply. And Europeans (plus Japan) are becoming increasingly angry at what is occurring. Thus the US is clearly blackmailing the hard currency nations, telling them (in terms of sliding dollars) that they had better inflate, that they had better start getting rid of their big surpluses, or they will surely choke (drown would be a better description) in a tide of decreasing-value dollars.

The next question is what do we (as investors and survivors) do about it? First of all, if the world (including US citizens) becomes frightened of holding too many dollars, you have the potential for an all-out flight from currency, and into "things" such as land, homes, commodities, gold, stamps, coins, art, collectibles, etc. That process is already well underway, and the fact is that people are pouring cash into all sorts of "store of value"items.

Question: I hear what you're saying, but these store-of-value items don't provide any yield. Therefore, isn't it a great sacrifice to own them?

Answer: Theoretically, yes. But the great irony of the situation is that the wealthy, the people who didn't need the income or who were willing to forego the income, these are the people who have been collecting and holding the store-of-value items. The "investment-minded" people who insisted on (or needed) income have been holding stocks and bonds for years. But Since 1966 (or for the past dozen years) the holders of store-of-value items have seen their treasures explode in value while those who have held stocks and bonds have seen their purchasing power slide badly.

Question: How do you account for this?

Answer: As I've said all along, people don't really trust the profit system any more, they don't trust the Government to leave business alone; they don't trust companies to retain their value and profitability in the face of the rising needs of the Government and the changing social and political winds that are sweeping the US and the world. Incidentally, a glaring example of this is the rise in the price of gold versus the almost static performance of the gold shares. I've said it before and I'll repeat it: investors want the gold, but they don't want the risk and the problems that go with the gold mines and the gold stocks (which include, of course, the Canadian and S.African political problems.) An even more glaring example is the diamond picture. The price of diamonds is going wild on the upside, but DeBeers, which produces most of the world's diamonds, is half its 1975 peak price of just under $10.

Question: Russell, in Letter 719 you showed a chart of the Commodity Price Index, which was then in a huge triangle. What do you see for commodities now?

Answer: The Commodity Index is still within the triangle, but one thing that could happen (in view of the trend toward "things," rather than equities) is an upside inflationary "blow-off" in commodities even while stocks are going nowhere. More and more I am convinced that on an increasing scale we are seeing a massive transfer of money from securities to tangible things. History shows that speculation runs along faddish lines, and the fad now is "anything but securities."

So the fact is that people continue to pour cash into store-of-value items because they are afraid of holding too many dollars and they are afraid of stocks and bonds. And this phase is probably going to last as long as the various stores-of-value continue to rise in terms of paper money.

Question: Up, up and away, Russell, but what happens if the price of things starts to come down?

Answer: If and when the price of things starts tumbling, you have the ingredients for a deflationary panic and depression. At that point the dollar may or may not hold its purchasing power. True, the dollar could increase in purchasing power (as it did during the 1930's). Or the world (which holds most of its monetary reserves in dollars) could simply go bankrupt. No one knows. This kind of debt has never faced the wringer before. We have no "previous examples."

Question: Great, Russell, that's really something to look forward to, but I'm still asking you what do we do?

Answer: The only answer I can come up with is the one I've been advocating month after month, and that is **diversification.** Now diversification is, in a way, a humble approach, and in a way it's an admission of defeat. Because when you diversify you're really saying, "I don't know the precise answer, I don't know the one or two categories that will stand up in the face of current conditions. So I'm diversifying into a number of categories because chances are some of them will do well and most of them will survive.

I have advocated holding about 10% to 20% of assets in gold, maybe another 20% in a collectible that you are familiar with such as stamps, coins, art objects, antique guns, you name it, or instead of collectibles, perhaps 20% of your assets should be in your home. Those who have a business have another valuable "survival vehicle." Finally, there's the big category of liquid assets which should now be in T-bills. With our liquid assets item we hope to move into the market when the time is right. We're hoping that the 50% or 60% or more of liquid assets will be our work-horse, producing profits, making up for the loss of purchasing power due to inflation, helping us to pay our expenses and taxes.

Question: Russell, if the picture becomes grim wouldn't the Government try to confiscate our gold? How safe is gold?

Answer: Well, I honestly think the Government would be very reluctant to confiscate gold. Remember, they just made gold legal in 1975. To confiscate it would be a terrible admission of defeat, particularly since the Government has claimed all along that gold is an ancient relic. Furthermore, this is a different world than that of the 1930's, and today I believe the Government would have one hell of a time trying to confiscate gold. I don't know how many people would turn their gold in. The collection problem would be horrendous.

Question: If this whole inflationary structure collapses into bankruptcy or say into deflation, what would happen to gold and collectibles? Couldn't they go down in price?

Answer: Certainly they could. If the whole edifice topples over, there could be a panic for liquidity. People would have to have purchasing power in order to survive, to pay their debts, to buy food, to get by day after day. In this case, they might have to sell store-of-value items, their collectibles, in order to survive. Such action could (at least temporarily) drive the price of things down.

It is possible that cash would hold its value (purchasing power) during any emergency short of a fall of the Government itself. Furthermore, during deflation cash would buy more. Thus cash would be a hedge during deflation. But I see your point. If the entire debt structure starts crashing, and the power of the Government itself becomes really suspect, then almost everything we have will decline in value except our brains and our strength and our ability to survive.

I always say that there is a point beyond which I refuse to worry, beyond which I refuse to figure and wrack my brain. If "everything goes" then we might just as well take a lesson from those old gold prospectors in the great motion picture, "Treasure of Sierra Madre." After sweating in the hills for months, after thirsting on the desert, being attacked by bandits and suffering the tortures of the damned, they go back to find their gold dust, pounds of it, has all blown away in the desert winds. So they sit down and cry–and they they start laughing. The picture closes with them laughing and laughing–until their sides are almost splitting. If it's all blown away–that's the way I want to go.

NOTES & QUOTES: Here's the latest on the Federal budget as I piece it together. Congress will probably provide a tax cut of around $30 billion, rather than the proposed $24.5 billion. Congress just isn't going to go along with a good many of Mr. Carter's tax reforms. Next, the economy is almost surely not going to grow at the projected 4.8%. The result is calculated to be a $10 billion **short-fall**. On the spending side, since 1977 was on the slow side (for spending) the odds are that 1978-79 is going to see a speed-up. Probable result, a huge deficit of $70 to $85 billion or even more. In celebration, the 91-day Treasury bills jumped last week to 6.5%. My bet is that they'll keep climbing.

* *

With the dollar as weak as it is, foreigners continue to buy up segments of the US with their surplus dollars. In 1968 foreign investment in the US totaled $294 million. By 1976 foreign investments had jumped to $1.7 billion. In 1976 foreign investments in the US had careened to $4.1 billion. Thus we hear of Germany's Thyssen Group taking over Budd, Bayer AG taking control of Miles, England's Schweppes taking over Peter Paul. For decades the US bought up the world with hard dollars. Now the world is buying up the US with its hard currencies and our own soft dollars. How have the mighty fallen!

* *

Inflation: In order to "stabilize" the dollar foreign central banks have been buying dollars with their currencies. These dollars (owned by foreigners) are then put to work, usually via massive purchases of US Treasury bills. For instance, Japan has been buying millions of dollars worth of T-bills recently, thereby helping to bring US interest rates down. The irony: if the dollar does stabilize, interest rates could rise as a major source of T-bill purchasing disappears.

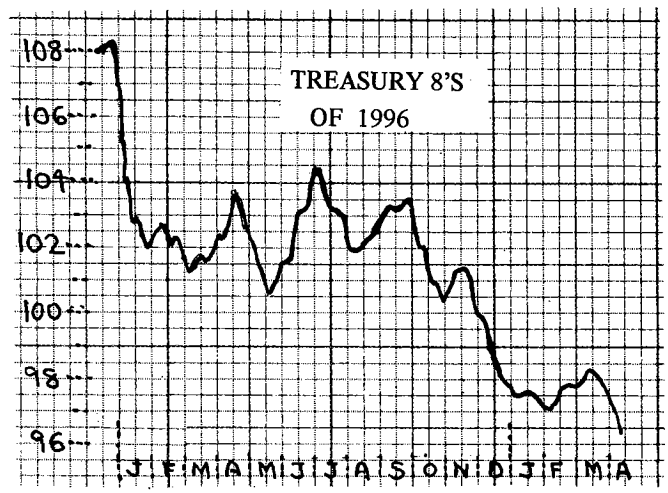
A second irony is seen in the process whereby a sinking dollar produces inflation. As the dollar declines, foreign goods cost more in th US. But instead of enjoying the competitive advantage of higher-priced foreign merchandise, the US manufacturers raise their prices (!) as witness the recent boosts on the part of General Motors and the steel companies. Thus, instead of protecting their position by becoming competitive and thereby producing more jobs, the US companies hit their workers (and everyone else) with higher prices and more inflation. In turn, the unions push for higher wages, and the round-robin goes on.

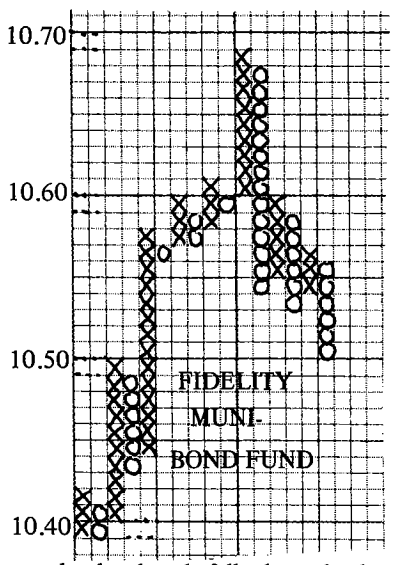
* *

"Those things he does one day, he undoes the next. No one understands what he wishes or intends and no one can rely on his resolutions." A modern-day description of Jimmy Carter? Well, it could be, but this was written by Machiavelli to describe the Emperor Maximillian. As you may remember, Maximillian was the effete emperor who lost the climactic war with France.

* *

There is a way out, Virginia. The way: the IMF is trying to gather $10 billion to give to the Less-Developed-Countries with the US taxpayers share being $1.7 billion. With these loans, the LDC's may be able to pay off the bank loans. One wag says we should call the bill, "The Bankers Relief Act of 1978."





BONDS & MONEY: With news of a record $4.5 billion trade deficit in February (almost beyond belief), with $230 billion in Government paper coming due within the next year, the bond market cracked wide last week. I drew this little chart to show what has happened to the bellwether US Treasury 8's of 1996. The bond was over 108 (actually $1080) in January, 1976. By February, 1978 the bond had dropped to 97, a searing drop of 10% (the drop was more than the coupon). Then last week the bond fell through the 97 barrier to 96½ where it yielded 8.3%. Where to from here? My guess is–further down for bonds as a weak dollar and a yawning trade deficit put intense pressure on the Fed to raise interest rates (to defend the dollar). If the Fed holds off, then it will have to face the consequences, which will be soaring inflation and even higher interest rates at a later date.

As a footnote, my P&F chart of Fidelity Municipal Bond Fund (the leading muni fund) fell apart last week as you can see (each box equals 1 cent on the chart). I've said this before, but I'll repeat it–I think Muni bonds are a sale.

GOLD, DOLLARS: The trade weighted dollar, measured against a basket of 14 currencies, dropped to a new low of minus 15% last week. Meanwhile gold pushed higher. I show

two views of gold on page 6. The P&F figure chart (each box equals one dollar) shows the huge base in gold which is still in the process of forming. At 190 (recorded in March) gold pushed temporarily *above* its upper channel line (arrow), indicating a bit too much enthusiasm. A correction then took gold back to 177, and the price movement is now consolidating as I indicated that it might.

My guess is that we could have a little more "work" (i.e., backing and filling) above 175 and more probably above 180. In fact, the more fluctuations in the 175-190 area, the more powerful will be the "right shoulder" that I believe is now forming. Ultimately, I feel we will see a move above 190, then above the all-time high of 197.50, and thence into the 200's.

My second chart is a daily showing the price of gold (second London fix) and a gold average made up of ASA and Campbell Red Lake (the prices of ASA and CRK are added and divided by two). What is so fascinating at this time is the weakness in the stocks and the resistance to the downside shown by the metal. Ordinarily, the two will confirm each other (one way or the other).

Since late-January the gold stocks have been reactionary whereas gold has been hitting new 1977-78 highs. In March both stocks and the metal declined, and as you can see the stocks broke below their February lows. Yet the metal has not confirmed on the downside, holding well above its February low. I take this non-confirmation as a bullish indication. I think it is telling us that the metal will not respond to gold share weakness, and it is telling us that the metal "wants" to go to new highs. Whether the stocks will follow is another story. But they should at least trend higher with the metal.

At this time I note a decided shakiness among gold proponents, a tendency to "cut and run" very quickly at any sign of decline in the price of gold. The general feeling seems to be, "Well, gold has done its job; it's risen from 103.50 almost to the old high. We were taken here before in the 190 area, and I don't want to get taken again. So any time gold pushes into the 190 area, be ready to sell out and take your profits." This attitude (and I think it prevails) is very bullish for gold. In my experience, very, very few investors ever ride through the greatest part of a bull market. Fear takes them out over and over again. The gold bull market will also be hard to ride through. There will be a dozen reasons a day to sell the metal. But I think that it will be worth hanging on.

YOU'RE KIDDING: A few months ago I did a humorous piece about an Arab sheik and his Jewish broker, Ziggy. A few subscribers wrote to tell me that there was no way this could occur. Well, the March 30 WSJ contained a news story on the Saudi Royal family and a gentleman in Atlanta who doesn't sound like an Irishman to me. I enclose a piece from this story, but only to prove one point. **Money is very democratic.** It searches out talent and brains, and it doesn't give a damn where it finds them!

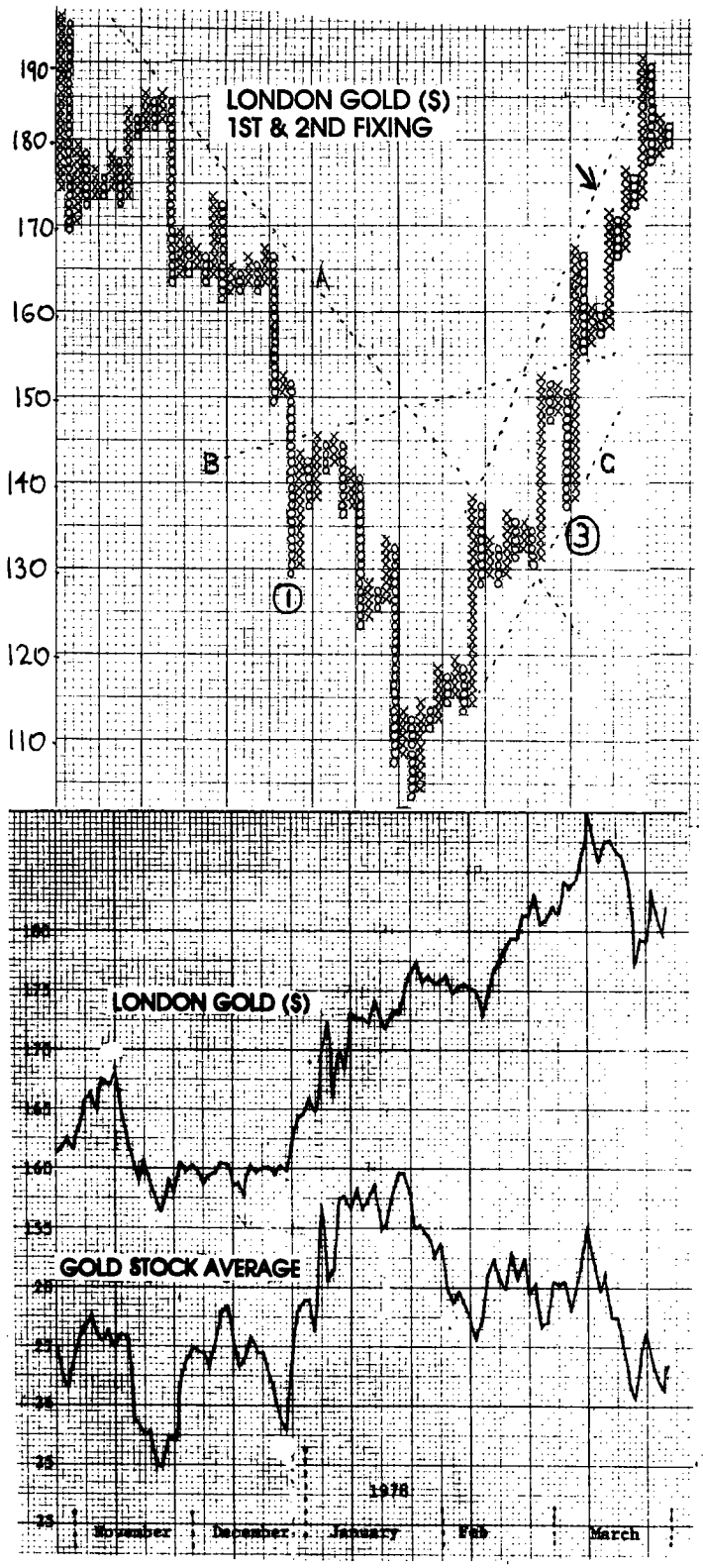
By a WALL STREET JOURNAL *Staff Reporter*

ATLANTA – An investment consulting firm said it signed a one-year contract to invest $500 million on behalf of two members of the royal family of Saudi Arabia.

Michael Rothberg, executive vice president of Corporate Finance Associates, said the contract establishes a trust enabling his clients to invest in businesses in North and South America and in U.S. real estate. Corporate Finance would recommend potential investments, he said.

Mr. Rothberg wouldn't identify his clients, but he said they live in Saudi Arabia and aren't planning to move to the U.S.

FOR NEW YORK SUBSCRIBERS: In accordance with the New York Investment Advisers Act, we have filed our Investment Advisor Statement and NY subscribers may obtain a copy of same upon request. A fee of $14 will be charged for xerox costs.



PARADISE: During June 1 through 4, the *National Committee for Monetary Reform* will hold its annual off-shore conference. This year it will be at the beautiful Loew's Paradise Island Hotel in Nassau, the Bahamas. I'll be speaking there as will friends such as Harry Schultz. Harry Browne, CV Myers, Bill Tehan, Julian Snyder and many others. There will also be workshops with stamp expert Mike Kaller, coin expert Judy Frank, and others. This is a top quality conference, and **it will sell out fast.** It's also limited in size. So if you're interested, call Jim Blanchard down in New Orleans at (504)865-7561 or (504)865-9919 and make your plans.

NEXT MAILING: April 14th